BUSINESS LOCATION, TAXES, AND PROPERTY TAXES

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PREFACE

This report deals with the topic of Academic Research on "Taxes and Business Location Decisions". It has been commissioned by The Civic Federation to be part of its Research Series on Taxes and Property Classification in Cook County.

BUSINESS LOCATION DECISIONS

Economists, geographers, and planners offer differing explanations as to why businesses locate where they do. As a body of accumulated knowledge, otherwise known as academic literature, the question of business location is grounded largely in economic theory with major application to the behavior of firms and specific industries (Watkins, 1980; Herrick and Kindleberger, 1983). As applied to firms' choices of geographic location, the general theory posits that a firm chooses its location to maximize its expected profits.

Prior to the 1980s, classical location theory provided a rather limited view on the forces that influence the spatial distribution of economic activities within an economy such as location of industrial firms. The least-cost theory of industrial location focused exclusively on the factors that influence the location of a specific industry (Losch, 1954). Location decisions balance both cost and demand considerations. Industrial location studies consistently cited four major location factors related to production costs: 1) transportation; 2) labor costs; 3) access to raw materials; and 4) external economies of agglomeration. The literature also accounted for demand -related factors as influenced by market conditions, which included the mix of size and relative income of specific markets. In this early period, taxes were not considered to be a major factor in business relocation decisions. Industry association claims to the contrary, those early site location studies based on surveys and interviews found respondents ranking tax considerations relatively low on the list of major location criteria (Watkins, Ch. 1, 1980).

Much changed in the 1980s. The literature came to reflect a better understanding of the location search process, and how taxes entered the location equation. Using Dun and Bradstreet data on Fortune 500 Companies with new branch locations, Roger Schmenner changed the debate over the relative impact of taxes upon business location decisions, particularly those within metro areas. He characterized the site location search in the context of a two-step process. In the first stage, the basic location screen considered major factors such as labor force, transportation, and market size, but not taxes. However, in the second stage, where major cost factors were more or less equal among finalists, tax differences could be a major factor in the final decision. Otherwise known as the "all things being equal" argument, taxes did matter but largely in the final stages of firm location decisions. Once a firm had decided to move (based on others factors) and it had narrowed the final site choice to several comparable places, relative operating cost differences as affected by taxes could influence the outcome (Schmenner, 1982). Schmenner's research also expanded the traditionally cited factors affecting locational choice to include such factors as quality of labor force, business climate, quality of life and more qualitative considerations. His data also supported the argument that existing business is a more important source of job growth than new or relocating firms.

Thus, taxes could not be dismissed from the site location process nor would one hold that differences in tax costs to locating firms had no impact on firm behavior. Attention next turned to the related issue of business location, namely the effectiveness of public policies that reduce taxes to attract business. If taxes matter, so the logic goes, then low taxes are preferable to high taxes in business attraction and retention. So, too, if taxes matter, then what can be said about business tax concessions, subsidies and other inducements that places (states and localities) offer to businesses to attract them? Recall the 1970s, a period of enormous economic upheaval, where states and localities responded to recessions, high inflation and unemployment, and increased foreign competition by aggressively seeking new industrial activity, investments, and plants through incentives.

What guidance has academic literature offered regarding such practices? Driven by the economic imperatives of least-cost production, such incentives aimed at reducing manufacturing inputs by means of low taxes, cheap labor and land, and other cost-reducing inducements (CED, 1986). Incentive bidding among competing places (so-called "smokestack chasing") escalated to new levels in the 1970s and early 1980s. While federal officials threatened to stem excessive state practices and credit rating agencies railed against distorted state fiscal practices, competition among states -- so called "Race - to - the Bottom" -- largely played itself out. The economic recession of 1991-92 and even greater foreign incentive packages helped moderate state bidding wars for business attraction. Most public sector economic development agencies still offer a range of business incentives: tax reduction, low cost financing, site location assistance, job training, and the like.

In this case, research conclusions regarding incentives tended to be more negative than not because: a) the net costs and benefits to the giver are not fully known; and b) the actual benefits to the receiver versus competing offers also are not usually known. Thus, as a business transaction, the giver rarely knows how much is actually needed to negotiate a deal. Little wonder, then, that studies find that inducements rarely work or work very well (Kenyon and Kincaid, Ch. 15, 1991; Hahn, 1996). Moreover, studies indicated that subsidies to business can distort location decisions and often prove to be a highly inefficient use of resources (Netzer, 1986). Subsidies rarely provide a sustainable advantage. Someone can always offer more or, conversely, a "foot-loose" firm moves on to the next best offer. They also may discriminate against existing firms which, as research suggests, is generally a greater source of job growth than new or relocating firms.

However, not all incentives are the same, and some cost little compared to others. They come in all varieties: supply side (attract new/expanding existing firms) and demand side (cultivate new start-ups); tax and non-tax; and be general or targeted and specific (Ihlanfeldt, 1995). They can be measured and ranked as to relative costs and benefits to parties to a location transaction, and can be assessed over time (Vaughan, 1984; Rasmussen, 1984; Bartik, 1991). The literature also recognizes the use of advocacy research which, in business incentive practices, is grounded in economic models and economic multipliers. While widely employed by governmental policymakers and agencies to justify specific incentive-based deals, these studies now invite much criticism from academic circles, particularly in their most recent variation -- public subsidies for sports facilities, stadiums, and convention centers. For a variety of reasons,

state and local governments invest little in evaluating the cost-effectiveness of incentives (Bartik, 1994).

WHAT'S DIFFERENT ABOUT THE 1990s?

Having concluded that taxes matter but largely in the final stages of industrial relocation decisions and that tax-driven economic development incentives generally fail to deliver net benefits to the giver, policymakers find that they receive insufficient academic guidance on specific actions or policies. They are told that taxes matter but, cutting them to attract or retain business, can be costly, inefficient, and may result in poor public policy. However, studies often qualify such findings with "it all depends" and stress the importance of being competitive. Where's the balance? The fact is that there is not much that states and localities do that does not affect their economies in some regard, and these policies, practices, and institutions may not be characterized as economic development. From this broader vantage, state tax breaks and subsidies are too narrow a focus to measure economic impacts, particularly in large urban states, and more appropriately should include those things that states do or can influence. That includes education, human resources, physical infrastructure, natural resources, knowledge and technology, fiscal management, and quality of life. This broader context of government activities more aptly defines state and local government roles in economic development (CED, 1984; Fosler, 1988).

What academics research is not a constant or static phenomenon, but dynamic due to a rapidly changing economic environment. What is different about the 1990s? Part of the answer lies with the new economics of technology and global competition which superseded and greatly modified much of what earlier studies deemed to be important as location factors. These changes, in turn, have greatly influenced how academics and practitioners alike view the topic of business location going forward today. This includes: a) specificity of location decisions; b) relative changes in rank order, priority, or relative importance of location factors; c) technology; d) globalization; and e) sectoral and industry differentiation -- manufacturing, retailing, and business services.

Location decisions have become more business-specific and much more detailed as to criteria governing location searches. Needs differ among industries and, within industries, whether domestic or international. They also differ within firms, whether at the corporate, division, or product level. Every firm has its own unique requirements, interests and concerns, and may weigh financial and non-financial factors differently. Consulting firms, such as The Fantus Company, now conduct worldwide searches on behalf of corporate clients seeking office and plant locations that meet specific requirements and individual needs (Ady, 1983; Satterthwaite, 1988; Harding, 1989). Place and site information is generated by multiple sources: governments, industries, trade associations, real estate, and commercial ventures on a global basis (KPMG, 1997). States, cities, metro and rural areas, regions, and even nations provide enormous amounts of readily accessible information on comparative costs of doing business and the relative value added by a place or location (Kotler, Haider and Rein, 1993). Given global markets and reduced trade barriers, business transactions and costs also have become more transparent, which invite comparisons unknown even a decade ago.

For large U.S. firms, site selection today involves a process of place elimination including in many cases at least one foreign or off-shore location among the three or so finalists. As Kanter notes of this new competition, “Globalization is surely one of the most powerful and pervasive influences on nations, businesses, workplaces, communities, and lives at the end of the Twentieth Century” (1995). The relative importance of least-cost production in location decisions also changed significantly in the 1980s and 1990s, particularly within the United States, where low-cost labor rarely provides a significant competitive advantage set against global location choices (Fosler, 1988; Industrial Competitiveness Report, 1995). People factors ascended in importance for U.S. locations -- their availability, skills, adaptability, and workplace attitude. A trained, educated and available work force moved to the top of the list in the business location literature and among surveys of employers’ needs. With an estimated 80 percent of all new jobs in the U.S. being created in the suburbs, education and work force skills increasingly affect business location and also impact commercial property values (Lachman, 1998). Intangibles such as quality of life, support for education, and community leadership have become more important as firms tend to be more conscious of multi-year investment decisions. David Birch argued early on that the factors important in business location decisions in the 1990s are in many cases the complete reverse or opposite those deemed critical in the 1970s (Birch, 1984; Haider, 1992).

Consider how technology has revolutionized location decisions. The Office of Technology Assessment, a research arm of the U.S. Congress, found that the “new technology system is creating an even more spatially dispersed and footloose economy”.....(and) is likely to recast industrial and residential location patterns” (1995). It already has, and will continue to do so at an accelerating pace. OTA’s report provided countless examples of how the information age (cyberspace and digital society) changes how we live and work, where we work, and how work is conducted. “Information technology, communication, travel and trade that link the world are revolutionary in their impact,” notes Kanter in her study of how businesses and places can gain from their new global opportunities (1995). Technology and globalization have become more interdependent, aptly illustrated by former Secretary of Labor Robert Reich’s concept of “techno-globalism,” where goods can be produced at several locations and assembled at others (1991). Such technology-driven changes apply equally to service producers where information providers and users know few boundaries. Thus, the business location literature, once centered upon the economics of industrial firms, is confined by neither geographic boundaries nor by type of business activity.

HOW IMPORTANT ARE TAXES?

Bartik's review of 84 tax impact studies conducted since 1979 is often cited as one of the more definitive studies giving credence to the assertion that taxes matter (1991). James Papke's study of business tax burdens and capital investment is another major source to support the proposition that taxes make a difference in business investments (1995). While economists and policymakers have long contested the issue of how state and local taxes affect business location decisions, the location debate has moved on to the broader context of how state-local tax policies affect business investment and economic growth.

If taxes matter and have substantial impacts, then how effective are state-local governments in shaping their tax structures to stimulate more growth, jobs, and investment (different but related issues insofar as tax structures and incentives have different impacts on labor and capital)? Are public policy interventions to achieve these objectives positive, negative, neutral or simply negligible? Should government's role be limited only to interventions to correct market failures and to provide a limited menu of public goods? Should it be more proactive in shaping private sector decisions and the marketplace? And to what degree is interjurisdictional (interstate and intrastate) competition on public service levels and tax systems beneficial or detrimental, healthy or destructive, for these governments? Prominent scholars in economics, political science, and public finance continuously rehash these issues. The prevailing view is that the effects of state - local growth policies and activities tend to be small and highly uncertain (Kenyon and Kincaid, 1991; Federal Reserve Bank of Chicago, 1996). Surely, state-local tax policies can be constructed, crafted or balanced to be more pro-growth than not. However, once governments take such actions there is no guarantee of results, particularly in light of market forces and the broader activities of the broader national economy.

Better methodologies and data notwithstanding, to what degree do taxes matter for what businesses and under what circumstances? When factories close and unemployment rises, and when commercial retail vacancies climb and real estate values fall, taxes become an easy target as a major cause of or contributor to economic decline. In the 1970s, for example, policymakers viewed tax and spending policies by states and localities to be major contributors to the length and depth of business economic cycles. That is, when the national economy faltered, the hardest hit regions, cities, and places incurred rising spending demands and loss of tax revenues. Their decisions to meet budgetary pressures by raising taxes and/or reducing expenditures, the so-called perversity hypothesis, were thought to aggravate economic conditions and, in cyclical fashion, prolong recessions. Such reasoning provided the impetus for federal countercylical assistance (fiscal stabilization) to economically depressed states and localities using these governments as instruments of macroeconomic policy in the 1973-1975 recession period (Ball, 1984; Fisher, 1989 Federal Reserve Bank of Chicago, 1996).

As discredited as federal countercyclical spending became as a national economic response to economic recessions, the 1980s produced new economic theories on how public policies stimulate economic growth. This argument held that governments' size, excessive taxes, and regulation restricted growth. The popular version, associated with economist Arthur Laffer and supply-side economics, was built on the notion that an inverse relationship exists between U.S. tax rates and government revenues. Beyond national debates on these issues during the

Reagan years, little Laffer-curve variations found fertile ground among state and local governments in which tax cuts would lead to increased investment, more economic growth and government tax revenues. Thus, theories also matter regarding taxes and growth, but the empirical evidence as what works is rather meager and episodic as one moves down the chain of governmental levels from federal to state, and then to the local level. Once again, studies of state-local policies suggest that the issue of growth stimulation is much larger than subnational governments' tax policies (CED, 1984).

However, while an aggregate review of statistical studies on taxes and business location seems conclusive on tax impacts, firm-specific evidence remains rather weak. Taxes seem to matter little as measured by a typical profile of a firm's operating costs. According to those in the site selection business, actual industrial site location decisions (first stage or screen) in the U.S. turn largely on three key issues: operating costs, operating conditions, and living conditions. In such manufacturing equations, where labor costs account for 30-40% and transportation and utilities 35-45% of operating costs, only 3-5% of operating costs can be attributed to local taxes. This is insignificant relative to other costs. In the service sector, labor accounts for 60-80% costs, while taxes generally account for 4-6% of operating costs (Federal Reserve Bank of Chicago, 1996). Taxes are all too often characterized as being an "irritant" and rarely rank highly as a prime reason for relocating a business in the goods producing sector. However, as will be discussed later, they can be a more powerful factor in the service sector where property taxes can impact commercial and retail location decisions.

The fact is state and local taxes may not be as significant a factor in location decisions as certain trade, business associations, and anti-tax groups would have us think. In the public's eye and those of state-local officials, why taxes are important stems from some very basic explanations of how we compete for public office and how public officials are held accountable (Kenyon and Kincaid, 1991). They are an inviting culprit for attack, a means for challengers to contest incumbents in elections, and serve as a major litmus test of an incumbent's record in office.

Survey research also indicates that firms making relocation moves seek a location where the tax structure is competitive. Relocating firms have come to expect places (states, counties, and local governments) to be concerned about their relative competitive position, and this includes taxes. They also expect to negotiate with public officials over tax and non-tax incentives, whether expanding at an existing site or in negotiations over an alternative site. Incentives are generally viewed as being a positive indicator of a place's favorable business climate (Baum, 1987; CED, 1986). Given these competitive forces, a pattern emerged regionally and nationally in the 1980s whereby a number of major states adjusted and moderated their tax structures to become more competitive. This was particularly the case following the 1986 federal tax reform, which lowered effective income tax rates.

Subsequent state actions involved a systematic reduction in top marginal tax rates among relatively high tax-rate states (U.S. ACIR, 1988). Papke also found a certain trending toward the tax mean to be the case among Great Lakes States where the forces of regional competition produced more equalized levels of taxation (Federal Reserve Bank of Chicago, 1996). State leaders have become more sensitive to border state differences in taxation which, arguably, has lessened interregional competition on taxes (Kenyon and Kincaid, 1991). The National

Governors Association's dealings with economic development issues and state incentive practices indicate their recognition of the harmful effects of interstate competition. A 1993 NGA Policy Statement on Economic Growth and Development Incentives stated: "Governors must be prepared to withstand the political pressure that may result when they announce that their state will not in a bidding war for a high-visibility, high impact project" (NGA, August, 1993). Various regional pacts and understandings among governments emerged; some, such as those among Midwestern Governors, even appear to be temporarily successful.

PROPERTY TAXES AS A SINGULAR FACTOR IN BUSINESS LOCATION - EXPANSION

Surely a single tax -- such as a mineral extraction, inheritance, sales or even user fee -- can have particular high impact on specific firms and investments. Economists have long noted the impacts of "tax border" problems. They cite the U.S. - Canadian border or excise/sales taxes in New England, New York City area, Illinois-Indiana and other geographical divisions that invite low tax jurisdictions to cluster small retail firms and, recently, larger retail/wholesale expansion, to exploit tax sensitive competition (Due, 1983; Holmes, 1995). A singular local tax disparity -- income, sales property, or user fee -- also invites local effects when large tax disparities are introduced within a metropolitan area.

Property taxes which provide almost three quarters of all local U.S. tax revenue in the 1990s (a dependence unchanged over the last 25 years) vary widely as to local use, burden, and the degree to which they can be constrained, shifted or muted. Its metropolitan-wide effects on business and investment have been documented in particular settings (McGuire, 1985; White, 1986; Papke, 1987). Any single tax that disproportionately falls upon one class of taxpayers as opposed to another is likely to affect economic activity by violating basic tax principles of neutrality. If one jurisdiction undertaxes owner-occupied housing while overtaxing income producing (industrial and commercial) property and another does the opposite, these differences are likely to produce interjurisdictional effects. Such externalities are likely to be negative. One likely impact is sub-optimal decisions made by home buyers who move toward lower tax jurisdictions while overtaxed businesses are likely to move in the opposite direction. The larger the local taxing disparities among property classes, the greater the distortive effects. Thus, it is not surprising to find that Cook County's property tax levels -- a combination of the interrelated factors of classification, equalization, and higher tax rates -- have been found to produce an adverse effect on the county's economic competitive position (Haider, 1985). Such distortions in tax policy also promote greater fragmentation of economic activity due to the ranges of consumer-investor choice which, in turn, contributes to wider fiscal disparities among taxing jurisdictions.

In a recent study of Evanston's property values, John McDonald employed a simple theoretical model to demonstrate the unfavorable economic effects of higher property tax rates on commercial investments. He found the quantity of commercial real estate (square footage) to be lower, rent paid by tenants to be higher, and the property value to be lower (1997). Empirical studies, however, have been less conclusive regarding tax effects as applied to commercial office space because market conditions and location factors differ. Various studies produce different

results regarding the degree to which tax liability is fully capitalized into an asset's value (Aaron, 1975). Findings turn on issues of property tax incidence: the proportion of property tax differences shifted backwards to owners or forward to renters. In reviewing these findings, McDonald cites three studies -- Wheaton (1984), Man (1995), and his own of downtown Chicago (1993) -- to establish a range of taxes shifted. He concludes that 30 percent of inter-jurisdictional differential in property taxes is shifted forward to tenants, while the remaining 70 percent is imposed on property owners in the form of lower property values (e.g. larger impact on owners than tenants). These studies are by no means conclusive, and all recommend more empirical studies of property tax incidence in various tax and market settings. Since commercial real estate markets in major urban areas often move in cyclical fashion, the relative impact of specific taxes on investment and value needs to be studied over longer periods. Taxes make a difference in how buildings/property are valued, as McDonald argues, but no definite studies have tested value considerations through several real estate cycles or the relationships between taxes, market fluctuations, and property values over time.

Turning to industrial property, the Boston Consulting Group's Report on "Strategies for Business Growth in Chicago's Neighborhoods" offers a recent, but limited sample of Chicago manufacturers who recently left the city (1998). Taxes, crime, and congestion were identified by respondents as being key dissatisfactions with their previous Chicago location, but were not considered to be sufficiently strong factors to drive relocation decisions. In fact, property taxes, per se, were not even mentioned as a major relocation issue. The number one relocation factor involved site availability. Chicago lacked suitable, available sites for industrial expansion. Once facility and proximity needs of these relocating firms were met, relative costs such as taxes became a more important relocation factor (1998). This, of course, concurs with Schmenner's earlier findings. BCG found that taxes were a significant competitive consideration for the next location within the region, which also supports earlier studies.

Respondents found Cook County's real estate tax burdens to be a significant competitive disadvantage for Cook County businesses. They also noted that Chicago's head tax on employees to be a nuisance and Illinois Workers Compensation costs higher than surrounding states. Tax issues tend to have compounded effects in employer surveys. No single tax generates a relocation action, but rather the cumulative effects of tax and regulatory issues can lead to a firm's out migration, particularly city to suburb. As in most surveys which probe politically sensitive matters, critics' fault the wording of questionnaires or the reliability of responses. In the BCG survey and other interjurisdictional surveys samples are sufficiently small as not to be generalizable.

Finally, the Chicago Metro area provides a fertile laboratory for testing how taxes, growth, population, and employment interact. In the first place, Illinois' property taxes are 20 percent above the national average and even more on income producing property classes within Cook County (McDonald, 1987). More than 1200 separate tax-levying jurisdictions exist in the six-county Chicago metro area, and such a large number promotes an enormous range in property wealth among these governmental units. Thus, one may ask, does business growth beget higher or lower property tax rates within a community? Does one community benefit from nonresidential development while another possibly loses due to the associated costs of providing

services caused by residential growth? How does economic growth and decline affect taxes, investments, and population growth among these competing units?

Oakland and Testa (1995) examined data on 1500 communities with populations over 10,000 within the six-county northeast Illinois region for the 1980-1990 period. Their study produced several interesting findings attributable to and driven by excessive property tax reliance by these local governments. As measured by increases in assessed property values, for example, business development tended to be associated with lower effective residential tax rates (e.g. inverse association between growth and tax rates). If this is the case, then local officials are quite rational in aggressively pursuing growth-oriented development objectives. More business in their communities can result in lower tax rates. Population growth was generally associated with increased residential tax burden (as a percent of personal income). Thus, population growth does increase tax burdens through increased service demands. More people and more jobs also result in higher taxes. High tax rates seemed to have a certain deterrent effect upon nonresidential development, but high rates did not detract from high residential property values. People were willing to pay high residential tax rates to live in certain areas whose effects are to separate home-buyers and communities by income and wealth.

What this extensive study also illustrates is the degree to which the question of tax impacts on business may neglect the systemic effects of tax policy on a whole range of spatial conditions -- growth, population, employment, and how individual communities seek to capture growth benefits. Oakland and Testa move beyond their limited conclusions to explore the dynamics of local property tax dependence and community resources, and its distributive effects on property wealth and business activity. They find that such conditions lead to poor decisions in land use, zoning, residential housing, and local pursuit of business development. In short, the literature on business location and

taxes opens up a much broader range of related issues and questions. Ultimately, these may be more interesting and relevant to complex public policy considerations at the state-local level than the singular or narrow question of how taxes relate to business location.

CONCLUSIONS

Academic studies in business location have changed over the past several decades: emphasis initially upon least cost advantages in location decisions and then to value added factors such as human resource and skilled labor availability; and from a regional competitive base to a more global context. Firms still locate to maximize expected profits while the specific demand and cost considerations have changed greatly. State-local taxes matter in industrial movement, but far less in highly capital intensive arena of U.S. manufacturing, where taxes amount to a relatively small component of operating costs. However, all things being equal in a location decision, taxes can be decisive.

Studies of state-local tax impact upon business investment, expansion, and location decisions may not provide definite answers or substantially prove causality. They largely refine, qualify, or shed varying degrees of light upon increasingly complex factors that affect business costs and

investments. Statistical studies are limited by time, sample, methodologies, and multiple variables within the context of a rapidly changing and technology-driven global economy. The literature also has become sufficiently diverse to move from an industrial focus alone to include commercial, retail, and a host of service producers.

Taxes tend to have greater impacts and make more of a difference in spatially confined arenas of competing locations, such as city to suburb and within a metropolitan area, than they do in a national or regional context. Taxes rarely make for business relocation decisions except where extremely tax-sensitive businesses and border considerations drive economic activity. However, once firms decide to move, their decision to pick one location over another -- selection among finalists -- can turn on tax factors which includes the willingness of a place to be competitive. Any time a place's tax structure moves a sufficient distance from tax neutrality on land, labor, or capital, adverse economic effects are likely to result. These can be distortive of economic decisions and inefficient as to resource use.

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